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BEFORE THE
POSTAL REGULATORY COMMISSION

Institutional Cost Contribution Requirement for Competitive Products	:	**DOCKET NO. RM2012-3**

REPLY COMMENTS OF UNITED PARCEL SERVICE ON NOTICE OF PROPOSED RULEMAKING TO EVALUATE THE INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS

(May 7, 2012)

UPS hereby replies to the comments of other parties on the Commission's review of the appropriate share of institutional costs to be paid by competitive products.

In the initial comments, UPS points out that competitive products' "appropriate share" contribution is one of PAEA's key safeguards for ensuring fair competition. Also, in light of the unsustainability of the current postal business model -- one which relies on rapidly-declining First-Class Mail volumes to generate the lion's share of institutional costs -- we recommend that the Commission revise the appropriate share rule to provide that there be a more proportional contribution from competitive products. UPS believes the appropriate share methodology should be self-adjusting to account automatically for relative changes between the market-dominant and competitive products groups.

PSA agrees that "[p]erhaps a more scalable or proportional requirement would better suit a more volatile postal market place of the future." PSA Comments (April 9,

2012) at 3. And UPS agrees with the Postal Service that money retained in the Competitive Products Fund (currently, over $1 billion) could be used to make up a contribution shortfall if competitive products fail to meet the required appropriate share in a given year. Postal Service Comments (April 10, 2012) at 10; UPS Comments (April 9, 2012) at 9. However, as set forth in our initial comments, UPS does not agree that the current appropriate share methodology should be retained as is, or that it should be eliminated altogether.

1. Competitive Products' Actual Contribution to Institutional Costs Has Not Exceeded the Appropriate Share (5.5%) of Total Institutional Costs Plus the Imputed Tax Payment.

Other commenters suggest that the appropriate share methodology should be retained as is, or that it should be eliminated or relaxed. Their reasoning relies, at least in part, on the assumption that all competitive revenues after payment of competitive products' attributable costs are contributed to institutional costs. For example, the Public Representative states that competitive products' appropriate share contribution has consistently exceeded 5.5%. Public Representative Comments (April 9, 2012) at 2. See also Miller Comments (April 10, 2012) at 14; Postal Service Comments at 5; PSA Motion to Extend Comment Period (February 24, 2012) at 3. We do not see how this assumption can be correct.

Each year under PAEA, competitive products have actually contributed only 5.5% of total institutional costs plus the relatively small imputed tax payment.[1] This is clear from the fact that the Competitive Products Fund balance has increased each year

1. In FY2011, the imputed tax payment of $242 million was less than 1% of total institutional costs ($29.554 billion). See Appendix A to UPS Comments.

by the exact amount of competitive product revenue remaining after the payment of attributable costs, the 5.5% appropriate share, and the imputed tax. See Appendix A to UPS Comments; FY2011 PRC Annual Compliance Determination (March 28, 2012) at 165-66.

The remaining revenue (collectively, over $1 billion) has not been used to pay for institutional costs, but rather has been used to increase the cumulative net income of the Competitive Products Fund. How, from an accounting standpoint -- or in any other respect -- can the same funds be used to increase the cumulative net income in the Competitive Products Fund while simultaneously having contributed to the payment of institutional costs? The percentages used by the other parties appear not to be contribution, but rather represent the extent to which competitive revenues exceed their attributable costs, expressed as a percentage of total institutional costs.

While postal revenues may be fungible for some purposes, they are not fungible under 39 U.S.C. §§ 2011(a)(2) and 3633(a). How and by which product grouping institutional costs are actually paid matters under the statute. The same money cannot be both retained earnings and contribution.

In short, as a factual matter, it appears that the appropriate share contribution has been a fixed 5.5% (plus the imputed tax), with the remainder being held in the Competitive Products Fund account. If this is the case, then the funds are not contributing to institutional costs.

This clarification is critical to a clear analysis of the current appropriate share method.

2. **Retaining the Current 5.5% Allocation Method Will Not Properly Address the Postal Service's Broken Business Model and Does Not Reflect Competitive Products' Increased Utilization of the Postal Network.**

Three commenters suggest that the Commission retain the appropriate share requirement in its current form. Postal Service Comments at 1; PSA Comments at 1; Public Representative Comments at 5-6. UPS disagrees.

Even assuming arguendo that all competitive revenues in excess of attributable costs were actually being used to pay institutional costs, the fact remains that competitive products now account for a greater share of the postal system. As we noted in the initial comments, competitive products' shares of postal revenue and attributable costs have risen sharply since the appropriate share level was initially set. See UPS Comments at 5-6. Yet, competitive products' contribution to institutional costs has fallen significantly behind pace, remaining stagnant at 5.5% (plus the imputed tax). At the same time, over $1 billion remains in the Competitive Products Fund rather than helping to offset the postal deficit, a deficit that has resulted from market-dominant products' inability to meet their approximately 94% allocated share of institutional costs. If the required contribution level remains fixed, this imbalance will continue to grow: competitive products' required contribution will stay at 5.5% plus the imputed tax even though their share of use of the postal system becomes increasingly larger.

A self-adjusting approach which increases or decreases with, for example, competitive products' share of total postal revenues would automatically gain more contribution from competitive products as competitive products earn a greater share of postal revenues, and would decrease if competitive products lose revenue share. Put simply, competitive products should contribute to institutional costs in a way that is more proportionate to their utilization of the Postal Service's network. If the allocation is not made more proportionate, the Postal Service's broken business model will continue to generate both insufficient funds from market-dominant products and a surplus of funds in the Competitive Products Fund.

A self-adjusting variable approach would also automatically account for transfers from the market-dominant group to the competitive group. As the Postal Service acknowledges, the recent transfers to the competitive products group of approximately a billion packages with substantial revenue weigh against a lower appropriate share contribution. Postal Service Comments at 9. See also Docket No. RM2007-1, Order No. 26 (August 15, 2007) at ¶ 3061 ("The Commission anticipates that [the] need [to revise the appropriate share] may arise for any number of reasons, *e.g.*, additions or deletions to the competitive product lists and market conditions"); Docket No. MC2009-19, Order No. 391 (January 13, 2010) at 29 ("The Commission agrees with UPS that the cumulative impact of adding products to the Competitive Product List must be evaluated.")[2]

The Postal Service states that the appropriate share requirement should be retained as is because there is no evidence that the Postal Service has engaged in predatory pricing. Postal Service Comments at 6-7. Nothing in PAEA suggests that the

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2. The recent transfers of First-Class Mail parcels and a substantial portion of Standard Mail parcels and the newly-proposed transfer of Single-Piece Parcel Post to the competitive products group are expected to generate more than $2 billion in added competitive revenue. See Docket No. CP2012-2, Competitive Product Contribution & Cost Coverage Analyses appended to Postal Service Notice of Rate Change (November 22, 2011) (in FY2012, First-Class Mail parcels expected to generate over $950 million in revenue and Lightweight Parcel Select expected to generate approximately $650 million in revenue) and FY2011 PRC Annual Compliance Determination at 32 (Single-Piece Parcel Post generated over $730 million in revenue in FY2011).

sole function of the appropriate share requirement is to prevent predatory pricing. The appropriate share requirement helps to accomplish PAEA's objective of fairness among mailers and competitors by requiring all mailers, not just market-dominant mailers, to pay an appropriate share of the postal network. See, e.g., 39 U.S.C. § 3622(b)(9) (market-dominant ratemaking objective of achieving a fair allocation of institutional costs for both product groupings).

Finally, the Commission should reject Mr. Miller's suggestion that the appropriate share be eliminated altogether. Miller Comments at 2. Mr. Miller's comments and equations assert that the Postal Service has an incentive to maximize its contribution to competitive products and that this therefore ensures that all competitive products collectively are covering what the Commission determines to be an appropriate share of the institutional costs of the Postal Service. See, e.g., Miller Comments at 2, 11. However, PAEA is not intended to ensure any level of market share or success for the Postal Service. Rather, the objective is the fair allocation of the burden of use of the postal system between market-dominant and competitive products. See S. Rep. No. 318, 108th Cong., 2d Sess. (2004) at 15, 45 (Commission must adopt regulations "ensuring" that competitive products cover "their share" of institutional costs). A desire for greater market share does not override the importance of this fair allocation.

Mr. Miller's approach could result in no contribution to institutional costs from competitive products (other than the imputed tax payment) and lead to increased postal deficits, combined with an even faster accumulation of competitive product revenues in the Competitive Products Fund. Further, his premise that the Postal Service is maximizing contribution to institutional costs is undercut by the fact that more than $1 billion in competitive revenue remains in the Competitive Products Fund rather than having been used to pay institutional costs.

3. The Commission Should Not Adopt A Regulation Allowing Competitive Products to Contribute Less Than the Commission-Designated Appropriate Share on an After-the-Fact, Case-by-Case Basis.

The Postal Service proposes that the Commission adopt a regulation allowing the Commission to find, on an after-the-fact basis, that contribution below the Commission-designated appropriate share is acceptable. Postal Service Comments at 9-10. There are serious questions about both the legality and the merits of this approach. For example, is it consistent with Section 3633(a)(3)'s requirement that the Commission "ensure that all competitive products collectively cover . . . an appropriate share of the institutional costs of the Postal Service" to adopt a regulation which says that if competitive products do not in fact achieve the required appropriate share, the Commission can change what it otherwise determined to be appropriate? The proposed rule also contains no standards for the Commission's exercise of such extraordinary discretion.

The Commission should reject this proposal. At the very least, it should not complicate this proceeding by entertaining the proposed rule in this docket. Competitive products have satisfied the Commission's appropriate share requirement each year, and there is no indication that these products will not do so, or cannot do so, in the near future. Rather, competitive products are making up an increasingly larger share of the postal system.

Should present circumstances change, the Commission may, if it believes its chosen appropriate share approach is not working as intended, commence a proceeding to change the methodology. See Order No. 1276 (March 7, 2012) at 4.

CONCLUSION

Competitive products' contribution to institutional costs is well below their increasing shares of total postal revenues and attributable costs. This imbalance will continue to grow as First-Class Mail revenue continues to decline and competitive products revenue grows. As a result, declining market-dominant volumes are left to pay more than their fair share of institutional costs -- something which they have already been unable to do. This is especially so as competitive products are contributing only the 5.5% appropriate share payment plus the imputed tax, regardless of their growing revenue share and increasing use of the Postal Service's integrated infrastructure.

The current approach is unsustainable. We urge the Commission to revise its appropriate share methodology to a variable approach that provides for a more proportional contribution from competitive products to the extent that the burden on the postal network shifts from market-dominant products to competitive products.

Respectfully submitted,

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